THE PUBLIC SUPERVISION OF WORKMEN'S COMPENSATION INSURANCE[1]

By E. H. Downey,

Special Deputy, Pennsylvania Insurance Department.

The essentially social character of workmen's compensation insurance is, happily, no longer open to debate. Experience has shown, and informed opinion has everywhere recognized, that efficient insurance is indispensable to the public purposes for which workmen's compensation laws are enacted. Work accident insurance is thus affected with a public interest paramount to every private consideration, and the right and duty of the state to conserve that interest, either through direct governmental agency or through public supervision of private insurers, will scarcely be denied even by the extremest advocates of private enterprise. Therefore, as respects those jurisdictions which allow commercial insurance to exploit this field, it becomes important to define the aims, the instrumentalities and the limitations of public supervision.

The objects aimed at in public supervision should evidently be coincident with the public interests which supervision is designed to conserve. These interests comprise the prompt and full payment of accruing compensation benefits, security of deferred payments, equitable rates as among insurants, encouragement of accident prevention and the furnishing of insurance at reasonable cost.[2] These objects are sought to be attained through the supervision of claim settlement, the licensing of insurance carriers, supervision of reserves and rate regulation. The first of these administrative divisions falls without the scope of the present inquiry; it is not specifically a problem of insurance, but belongs to the general sub-

[1] This paper overlaps to a considerable extent an article on the "Organization of Workmen's Compensation Insurance" in *The Journal of Political Economy* for December, 1916, which article had already gone to press when the request for the present paper was received.

[2] For a fuller statement of the social ends of workmen's compensation insurance see an article by the present writer in *The Journal of Political Economy*, Dec., 1916.

ject of workmen's compensation administration. The remaining topics will be dealt with in the order named.

THE LICENSING OF COMPENSATION INSURERS

Compensation insurance, in most states, is restricted to authorized insurers—a restriction which is practically enforced by penalizing the employer for failure to obtain authorized insurance.[3] The objects of such authorization are two: to exclude unsound or irresponsible insurers and to bring every carrier of compensation insurance within the jurisdiction of the particular state concerned. The latter purpose is effected by designating the insurance commissioner as the insurer's attorney for the service of legal processes and by empowering him to revoke the license of any insurer which fails to comply with statutory requirements. Licensing is thus the beginning of supervision, for insurance is a business which may be carried on by mail without resident agents to punish or local property to seize so that, if unlicensed carriers were permitted to operate, there would be no practical method either of enforcing their solvency or of regulating their practices. But, while the states have taken good care to assert their jurisdiction over insurance carriers, the laws governing the admission of insurers are altogether too lax to secure financial responsibility. Stock companies, indeed, are required to possess a certain modicum of unimpaired capital, but this resource need not bear any stated relation to the amount of insurance in force, nor is any part of it set aside for compensation, as distinguished from other, liabilities. Similarly, mutuals and interinsurers must have the power to assess insurants, which takes the place of capital stock. Given a sufficient spread of risk, this assessment power is evidently an excellent security—few stock companies can show combined capital and surplus equal to one annual premium. Unfortunately, however, most states permit the organization of mutual or reciprocal insurers upon an utterly insufficient basis. Wisconsin requires the coverage merely of 1,500 employes, New York of 3,000, and Pennsylvania of 5,000. The annual premium upon 5,000 employes in a low rated industry may not equal a single death benefit. The fruit of such legislative folly is seen in

[3] Self-insurance, so called, will come within this category in those states which permit an employer to carry his own risk upon obtaining proper administrative authorization.

the closing out of three compensation mutuals and the more or less compulsory retirement of eight stock companies within the present year.

The weakness of the present licensing laws is apparently traceable to the American fetich of free competition. It is felt that stringent requirements for the admission of insurers would hinder the development of new companies and give an unfair advantage to stronger competitors. But this is to overlook the fundamental requirements of the case. Compensation exists for the protection of injured workmen and their dependents. The public interest in furnishing this protection—an interest expressly avowed in the legal obligation to insure—ought not to be prostituted to the profits of insurance promoters or even to the employer's right to purchase insurance where he pleases. Wherever, therefore, a private insurer, whether stock or mutual, is permitted to assume this public function, it should be required to possess a substantial volume of assets over and above incurred liabilities. A net surplus, not less in any case than five maximum death benefits nor less than 50 per cent of one year's premiums, and devoted irrevocably to compensation obligations, would seem to be the minimum requirement consistent with security.

RESERVE REQUIREMENTS

The compensation liabilities of an insurance carrier fall into three readily distinguishable categories: deferred payments on account of accidents which have already occurred, payments to be incurred by reason of ordinary accidents during the unexpired portion of existing insurance contracts, and payments on account of a possible catastrophe. The assets held against these several liabilities, present or prospective, are commonly known, respectively, as claim-loss, unearned-premium, and catastrophe reserves. Failure to keep in mind the very different requirements of these distinct types of reserves is responsible for not a few of the shortcomings in current insurance law and practice.

The importance of claim reserves is directly proportionate to the adequacy of compensation benefits. Any reasonably sufficient indemnity for work accidents must comprise life pensions to workmen who are permanently disabled and pensions for the whole period of dependency to the widows and orphans of those who are

killed in the course of employment. Since these pensions, in the aggregate, will greatly exceed the cost of temporary disabilities and of medical relief, much the greater part of the benefits incurred in any given year, under an adequate compensation law, will take the form of deferred payments. Even under the limited benefit provisions of most American acts, there are numerous liabilities running for long terms of years and thousands of families whose standard of life depends upon the security of future compensation payments. To an insurance monopoly, these deferred obligations need occasion no concern, for it is always in the power of a monopolistic insurer to meet current payments out of current assessments.[4] But the case is quite otherwise when the law permits free choice among competing insurers. The accrued cost plan of premium assessment is as inapplicable to competitive compensation insurance as to competitive life insurance, and for a somewhat similar reason. Current payments on account of accidents occurring in a given year are but a fraction of the ultimate liability; assessments, consequently, are low at the outset and only gradually approach their limit of full-reserve or incurred-cost premiums. Hence a new assessment insurer can always deplete the membership of an older rival which has already attained a high level of accrued payments. In compensation insurance, therefore, just as in life insurance, there can be no security for the deferred obligations of a competitive insurer save by means of adequate reserves. Under competitive conditions, accordingly, the maintenance of adequate reserves becomes the first duty of supervising authorities.

It must be owned that this elementary task of public supervision falls much short of fulfillment in the United States. The existing reserve law, designed originally for liability insurance, is notoriously inadequate for the conditions created by workmen's compensation. Its fundamental defect is the basing of reserves upon a fixed percentage of premium income—to wit, 54 per cent of earned premiums, less losses and loss expenses paid. By this

[4] The West Virginia State Fund, *e.g.*, is technically insolvent in that its assets in hand do not equal its outstanding liabilities. This fact, however, does not at all jeopardize the payment of claims. Payment has never been suspended and the deficit accumulated from the period of inadequate rates is being gradually extinguished by current assessments.

The statement in the text would, of course, not hold unless the monopoly possesses full assessment power and covers a substantial volume of industry.

maladroit device, either inadequate rates or abnormal losses will infallibly produce insufficient reserves. Moreover, it is just the small and weak companies, most in need of stringent reserve requirements, that are most exposed to both these contingencies. Weak companies notoriously are addicted to rate cutting, some of them operating at the present moment upon rates which are below pure premiums, at the same time that their expense ratio is much above the average for well-managed companies. Small companies, also, because of their limited risk distribution, are peculiarly liable to wide fluctuations of loss experience, while their very weakness drives them to an adverse selection of business. Inadequate reserves, accordingly, characterize weak companies under the present law—and the worse their experience, the smaller their reserves, not only relatively but absolutely. Given a loss ratio of 100 per cent—a ratio by no means unheard of in actual experience—loss and loss expense payments will easily absorb the full legal reserve, leaving a large balance of uncovered liabilities. To make a bad matter worse, the stipulated reserve is insufficient even for a normal experience with adequate rates. The present rates of leading companies are calculated upon an average loss ratio of 60 per cent, with an expense loading which includes 7 per cent of premium for claim adjustment.[5] The reserve law assumes, in other words, that 54 cents of assets will discharge 67 cents of indebtedness. Lastly, there is no segregation of compensation from totally unrelated liabilities, so that the security of compensation benefits is bound up with the general solvency of miscellaneous insurance carriers.

The shortcomings of the present reserve law have long been recognized. The proper remedies have been a subject of much discussion by companies and supervising authorities which has at length eventuated in a bill brought forward by the appropriate committee of the National Convention of Insurance Commissioners. This bill provides, in substance, that the reserves upon compensation policies issued more than three years prior to the date of valuation shall be the present value of future payments, and the reserves upon policies of later years of issue shall be 65 per cent of earned premium, less losses and loss expenses paid, subject, however, to the further requirement that the reserves on policies issued more than

[5] See *Proceedings of the Joint Conference on Workmen's Compensation Insurance Rates*, 1915 (New York Insurance Department), p. 24.

two years before the date of valuation shall be at least equal to the present value of future payments. The merits of the bill are that it increases the percentage basis of reserve and that it provides for an actual valuation of claims under all but the last two years of account. Its weaknesses are that it prescribes no method of individual claim valuation, that its required percentage of earned premium is insufficient to cover losses and loss expenses under present rates with average losses, that it allows three years to elapse before even this level will be attained, that it makes no provision (except a doubtful administrative discretion) for cut rate companies or companies with worse than average experience, that it permits the deduction of adjustment expense from compensation reserves, and that it fails to separate compensation from general liability obligations. Inasmuch as this bill is likely to be enacted in all compensation states and to afford the standard of compensation reserves for many years to come, it seems worth while to develop these criticisms at some length.

(1) There is at present no recognized standard for the valuation of compensation claims. Death benefits, indeed, when once the dependents are known, as also certain enumerated permanent disability benefits, are of determinate amount. Reserves for such claims can be set up on the basis of known future payments, fixed by statute or by an award of the compensation board. Other injuries, however, are of slow development, insomuch that their ultimate result cannot be known until the lapse of months, or even years from the date of accident. Reserves for this class of claims are set up on the basis of the claim adjuster's personal judgment as to the probable future development of each case. The result, too often, is a systematic undervaluation. Claim adjusters are apt to be optimistic by reason of their occupation—they earn their salaries by minimizing claim cost. The method, moreover, produces wide variations between different insurers in the valuation of similar claims, and it makes the work of an insurance department examiner extremely difficult, since, in case of dispute, he can oppose only his own judgment to the judgment of the insurer.

(2) It needs no argument to show that 65 per cent of earned premiums is not equal to 67 per cent. But this is only a part of the difficulty. With respect to policies of the last year's issue, the reserve is based, not upon actual earned premiums, but upon one-

half of the deposit premiums, which, upon the average, will amount to scarce 80 per cent of the final audited premiums. More concretely, the losses and loss expenses incurred as of December 31 upon policies of the current year's issue should be, upon the average, 33.5 per cent (67 x .50) of the final audited premiums, wheras the legal reserve is but 26 per cent (40 x .65). Further, since adjustment costs already paid are subtracted from reserves, abnormal adjustment costs operate, by so much, to impair the sufficiency of claim reserves. A company which maintains an adjustment cost of 10 per cent—a figure considerably exceeded by more than one compensation insurance carrier [6]—would have net claim reserves of 22 per cent of final premiums upon the current year's business, and of 55 per cent upon the business of earlier years—a total deficit equal to 18 per cent of one annual premium in the course of three years.

Thus far the discussion has assumed a broad distribution of business throughout the country, such as would justify the presumed average loss ratio of 60 per cent. But not a few carriers are confined to particular states and in several of these states the rates are predicated upon a loss ratio higher than the average for the whole country—namely, 65 per cent in New York and 62½ per cent in Massachusetts, Wisconsin and California. That 65 per cent of earned premiums will not pay the losses and loss expenses of carriers limited to these states is beyond the pale of argument. Neither can it be assumed that the business of any carrier is distributed among the several compensation states in the same proportions as the aggregate business of all carriers—indeed the exact contrary is known to be true. Nor is the alleged reason for a flat percentage anything more than specious. Compensation premiums are necessarily segregated by states and the computation of reserves by the method of law differentials would present much less difficulty than the computation of rates by the same method.

Still more serious than any of the deficiencies already pointed out is the failure to take effective account of inadequate rates or of worse than average loss experience. The pending bill does, indeed, authorize the insurance commissioner to increase the reserves of a company if he shall deem the same inadequate, but it affords no

[6] Cf. *Workmen's Compensation Insurance Report* of the Industrial Commission of Wisconsin, 1915, Table IV, and 1916, Table IV.

concrete test of inadequacy and it leaves in full effect that interstate comity which makes commissioners reluctant to exercise discretionary powers as against a company which is countenanced by the authorities of its home state. The pending bill thus perpetuates the vital defect of the existing law, in that all of its assumptions look to the collective experience of well managed companies. The liability of insurers is not joint, but several. It is not sufficient that the *aggregate* reserves of all carriers shall equal their aggregate liabilities; reserves must be adequate for *each* carrier.

(3) The three years' grace allowed the companies in which to reach the new reserve level is grounded upon a singular conception of public supervision—the conception, namely, that the main office of insurance departments is to conserve the interests of insurance carriers. Viewed in the light of obvious public interests, it would seem elementary that an insurer which has not sufficient assets to meet its incurred liabilities should be compelled to increase its resources or retire from business.

(4) Last, and by no means least, among the many shortcomings of the pending bill is its failure to set aside any explicit fund for the payment of compensation benefits. The great bulk of workmen's compensation premiums, aside from exclusive state funds, are written by casualty companies engaged in boiler, flywheel, elevator, automobile, personal accident and general liability insurance. Many compensation insurers derive much more than half of their premiums from these miscellaneous lines, so that their ability to discharge compensation obligations is inextricably bound up with their general liability experience. Yet general liability premiums are nowhere regulated, nor are liability reserves subject to any such definite control in the way of claim valuation as may be applied to compensation reserves. The two branches of insurance have nothing in common save that, by an historical accident, both happen to be carried by the same insurers. Liability insurance bears less of a public character than almost any other branch of underwriting; compensation insurance owes its very being to an act of legislation, it exists solely for the performance of a public function and its carriers stand in fiduciary relationship to thousands of beneficiaries who are not parties to the insurance contract, and who have no voice in the selection of their insurers. That the rights of these beneficiaries should be jeopardized, and the very

purpose of compensation laws defeated, by poor underwriting in some totally unrelated field of insurance enterprise is altogether intolerable.

A somewhat singular reply to certain of the criticisms leveled against the pending bill is that it requires an excessive reserve for unearned premiums which excess tends to offset the deficit in claim reserves. This alleged surplus derives from two sources: (a) acquisition cost (normally $17\frac{1}{2}$ per cent) which has already been paid upon the whole deposit premium, and (b) excess collections on pay-roll audits, which may be taken on the average at 20 per cent of final, or 25 per cent of deposit, premiums. Stated arithmetically, 67 per cent of actual unearned premiums, or 33.5 per cent of the final premiums for the current year, should suffice to meet losses and loss expenses to be incurred during the unexpired portion of existing policy contracts, whereas the legal reserve is one half of the premiums in force (say 40 per cent of final premiums for the year). Taking into consideration the normal premium increases on pay-roll audits, less acquisition cost thereon, the unearned premium reserve may yield a substantial margin over claim and claim expense requirements for unexpired policy terms. This possible margin, however, is very far from providing reliable assets for the payment of claims. If the company continues in business it will incur, against unearned premiums, many expenses aside from acquisition and claim adjustment; if it is wound up, the cost of a receivership is no light matter. Prospective premium increases, in particular, are wholly problematical; in any given case there may be, instead, a net final return to policyholders. The utmost that can be hoped from this resource is an offset to the underestimate of earned premiums for the current year. This would leave a net surplus in the unearned premium reserve equal to the acquisition cost thereon—certainly not an excessive margin to cover the contingencies of reinsurance or of closing out.

The third division of compensation reserves—provision against catastrophe loss—is strangely ignored by the present laws. Most compensation insurers do carry excess insurance, either in London Lloyds or in a pool of stock companies. So far as legal requirements go, however, a mutual with $25,000 of premium income, or a stock company with $200,000 of capital and surplus, may assume unlimited liability upon any risk whatever.

It is not to be inferred from the foregoing strictures upon present and proposed reserve laws that a majority of compensation insurers are fast approaching bankruptcy. On the contrary, most of the large companies, both stock and mutual, are thoroughly sound and would continue to be so in the absence of any legal restrictions whatsoever. The point to be emphasized is that the soundness of these companies is due to the business policy of their management, and not at all to state supervision. That other carriers are not so fortunately situated is sufficiently indicated by the number of enforced withdrawals within the past three years. Nor is it necessary to wait for disastrous failures before taking effective means to prevent them. Having regard to the peculiarly public functions of compensation insurance, and to the fiduciary character with which the state itself has vested compensation insurers, the state should see to it that compensation claims can not be jeopardized by any failure of integrity or of business foresight on the part of insurance management. On every ground of social policy, compensation benefits should be surrounded by safeguards at least as effective as those which hedge about savings deposits, trust funds or life insurance policies.

If the foregoing analysis is at all correct, the laws relating to workmen's compensation reserves should be amended in the following particulars:

(1) Reserves of indubitable adequacy to meet all incurred claims should be set aside as a trust fund, invested in designated classes of high grade securities and held solely for the payment of compensation benefits. Claims arising under all policies save the last year's issue should be valued upon the basis of a standard table to be prescribed by the National Convention of Insurance Commissioners, with the further proviso that reserves for the last three years of issue should at least equal the calculated normal loss ratio for each state,[7] less compensation benefits actually paid. To the reserves so produced should be added at least 10 per cent to cover future adjustment cost. All this is in addition to the unearned premium reserve which probably should be maintained at the full amount as a further precaution.

[7] *I.e.*, from 57½ to 65 per cent of earned premiums, according to the law differential. With respect to current policies, earned premiums should be ascertained by a monthly computation.

The valuation table above spoken of would comprise three elements: (a) claims for known amounts, as accrued benefits, medical bills received, and the like, which should be taken at the face value; (b) claims for ascertained degrees of dependence or disability, including death benefits to known dependents and permanent disability benefits fixed by statute or award, all of which should be valued on the basis of mortality and interest; and (c) claims for injuries of unascertained gravity. Here would fall all that large class of long continuing disabilities which ultimately result in death or permanent disability, but whose permanence has not been ascertained at the date of valuation, as also claims not yet reported and all undetermined notices of recent date. All liabilities within this category should apparently be valued upon the basis of a standard distribution of accidents by ultimate nature of injury and extent of disability, similar to the well-known Rubinow table, only carried out with reference to the degree of maturity at the date of valuation. Thus, *e.g.*, the table should show the ultimate development of accidents arising under policies of each of the last three years of issue and still indeterminate (as to degree of dependence or extent of disability) at the date of valuation; or it might be constructed to show the ultimate average severity of injuries distributed by elapsed time from the date of accident.[8] In either event, such a table would furnish a far more trustworthy, uniform and

[8] Tables in the last mentioned form (though constructed upon very unsatisfactory data) have been promulgated by the New York and Pennsylvania Insurance Departments.

The table tentatively suggested in the text might take the following form:

DISTRIBUTION OF 10,000 ACCIDENTS ARISING UNDER POLICIES OF EACH YEAR'S ISSUE AND STILL INDETERMINATE DECEMBER 31, 1920

Ultimate result	1920	1919	1918	1917	1916	1915	1914	1913	1912
Death									
Permanent total disability									
Permanent partial disability of each specified degree									
Temporary disability of each specified duration									

verifiable basis of reserves than can ever be obtained by the haphazard methods of judgment estimates. Fortunately, the National Convention of Insurance Commissioners has already taken steps looking to the preparation of a standard valuation table to be derived from data compiled by leading insurance carriers.[9] The immediate object in view is a more uniform estimate of outstandings for classification of pure premium experience, but the same methods can obviously be applied to reserve computations.

(2) Capital or surplus equal to at least 50 per cent of the annual compensation premiums, but in no case less than $50,000, securely invested and assigned exclusively to compensation liability, should be a condition precedent to the writing of compensation insurance.

(3) Sound excess insurance, equal to the maximum catastrophe liability of the carrier involved, should be required of every compensation insurer.

RATE REGULATION

Rate control bears upon the security of future compensation benefits, in that rate cutting is the royal road to bankruptcy. Ostensibly, indeed, the safeguarding of beneficiaries is a chief end of adequate rate legislation. Very little analysis, however, will suffice to show that this object is mostly specious. The maintenance of adequate rates for compensation insurance in a single state will not serve to prevent ruinous rate cutting in other states or in other lines of insurance, nor will it prevent the dissipation of assets through extravagant management, poor selection of risks or unwise investments. A proper reserve law will absolutely protect the interests of beneficiaries, irrespective of rates, whereas an adequate rate law, at best, is but an indirect and ineffectual means to that end. The effective motive of rate regulation, then, is to be sought in the desire to promote fair dealing as among insured and fair competition as among insurers.

Rate regulation in the interest of insurants springs directly from the public character of compensation insurance. Indemnity for work accidents being a burden imposed by law, the state is morally bound to see to it that the burden is neither excessive in

[9] Mr. H. E. Ryan, of the New York Insurance Department, was a prime mover in this proposal.

proportion to benefits, nor unfairly distributed. What constitutes a reasonable insurance cost or an equitable distribution thereof will depend, of course, upon current economic-juridical conceptions, for there can be no absolute criterion of either reasonableness or equity. So far as prevalent opinion may be said to have decided these points, a reasonable rate, under competitive conditions, is one which will cover both the benefits to be paid and the expenses of insurance management as ordinarily conducted, while an equitable rate under a given scale of benefits and given expenses of management is a rate proportionate to the accident hazard of the particular risk insured. The maintenance of rates which will meet these tests would seem to be the most appropriate object of public rate supervision.

Curiously enough, however, rate regulation, in practice, is mainly directed to the protection of insurers against each other. So far as can be gathered, both from the laws themselves and from the spirit in which they are administered, the demand for rate supervision in this sense derives from a characteristic American prejudice in favor of competitive enterprise. Most of the states, in providing indemnity for work accidents, avoided anything like a comprehensive organization of accident insurance. Instead, they have deliberately encouraged a multiplicity of competing insurers—stock, mutual and state—trusting, apparently, that competitive selection will ultimately determine the form of insurance organization best adapted to this particular field. It is evident, however, that unrestricted competition between insurers of very unequal resources might well result in substantial monopoly by a few strong companies—a monopoly based, not upon economy or efficiency, but upon the financial ability to survive a prolonged period of deficient rates and ruinous selling costs. Hence, in order to preserve the competitive principle, it has been thought necessary to impose restraints upon its free exercise, both by prohibiting discriminatory rate cutting and by requiring the maintenance of adequate rates. At first blush a law which denounces insufficient, rather than excessive rates, is the very antithesis of the familiar anti-trust legislation. Yet in actual purpose, and in underlying preconceptions, the two sets of statutes are closely analagous.

The extreme reach of rate regulation, as hitherto applied to workmen's compensation insurance in this country, is marked by

the adequate rate laws of Maine, Massachusetts, New York, Pennsylvania, Maryland, Kentucky, Colorado and California. Only one of these acts (Kentucky's) prohibits unreasonable rates; none of them contains any definition of adequacy or any explicit requirement that the rates of different insurers shall be uniform, while some even neglect to forbid unfair discrimination among insured. Legally, therefore, each insurer is free to devise such classifications, rules, rates and merit rating as may seem good to it, subject to the single proviso that it shall not charge less than the rates approved by the supervising authority as adequate for such insurer.[10] Strictly interpreted, this latter phrase would seem to require different rates for different carriers, for it is well known that both loss and expense ratios vary widely as among insurers. Administratively, however, adequate rates have everywhere been held to mean rates sufficient to cover the average pure premium upon each classification plus the average expense ratio of well-managed stock companies, without other allowance for profit than the investment income from reserves. In practice, accordingly, only one set of classifications, rules and rates, and only one plan of merit rating, has been approved in each adequate rate state.[11] So far as the adequate rate laws, thus interpreted, are effectually enforced, the premium charge on any given risk is uniform for all insurers. The sole officially countenanced exception to this uniformity is that participating carriers are permitted to return, as dividends to policyholders, whatever they are able to save in either losses or expenses.[12] Nominally, indeed, except in Kentucky, any insurer may charge more than the approved rates, provided it does so without unfair discrimination, but practically nothing of the sort is either feasible or attempted. Not only

[10] Kentucky requires that rates shall be reasonable as well as adequate.

[11] In Massachusetts and Pennsylvania certain mutuals are required to charge more than the approved basis rates in view of their high dividend policy. The Pennsylvania State Workmen's Insurance Fund is permitted to charge 10 per cent less than the rates approved for other insurers on the ground that its expenses of management are paid by the state.

[12] This exception is entirely consonant with the theory of adequate rate laws as above explained. The laws seek, among other things, to maintain fair competition between different types of insurance management, each offering its own peculiar advantages for the selection of insurants. A principal advantage claimed for mutual insurance is its lower cost, to offset which stock companies claim to furnish a superior degree of protection and of service.

does the legal minimum thus become the actual maximum; the enforcement of uniformity, in the presence of mutual competition, tends to keep rates at the lowest level consistent with stock company management.

The maintenance of uniform rates is evidently a far more difficult undertaking than the maintenance of adequate reserves. The latter involves no more than the valuation of claims and the scrutiny of investments. The former touches every incident of underwriting: the construction of classifications and their application to individual risks, the calculation of pure premiums and expense loadings, policy forms, the application of merit rating, even the audit of pay rolls and the actual collection of premiums. Uniformity must extend even to the least of these matters, because premium income can be as easily impaired by misclassification, excess coverage, fictitious "merit" credits, or understatement of pay roll, as by direct rate cutting. Nor is it sufficient to lay down uniform rules of underwriting; these rules must be actually carried out in respect of every policy underwritten. Rate supervision, in short, involves both rate making and rate enforcement: on the one hand, the elaboration of a detailed, uniform code of classifications, rules, rates and merit rating charges or credits; on the other hand, day by day observance of the application of this code to the underwriting of individual risks.

Manifestly, rate supervision in this comprehensive sense cannot be effected without elaborate administrative machinery. It is necessary, in the first place, to base rate approval upon adequate and disinterested information. Rate making is only to a limited extent a matter of mathematical computation. The very classifications for which rates are to be computed, the extent to which given statistical experience can be taken as typical or has been affected by errors of sampling, the effect of merit rating upon accident frequency and severity, the allowance to be made for varying effectiveness of claim supervision in different jurisdictions, even the accuracy of reported expense ratios, are all subjects for the exercise of trained judgment—subjects, too, as to which informed opinions will differ and the proposals of insurers be biased by competitive interest. Nor can these difficulties be disposed of once for all. Conditions are ever changing and the great code of classifications, rules and rates must be periodically revised to meet the exigencies of the

business. Rate approval, then, demands adequate, continuous machinery for the furnishing of information and advice. Similar machinery, in the second place, is no less necessary for rate enforcement. Reliance upon individual complaints of violations is altogether futile, for the same reason that the like judicial process has failed in every attempt to regulate intricate business activities. Complaints are rarely made because insurance agents who have knowledge of departures from approved rates usually are unwilling to risk the enmity of prospective insurants—it is simpler and more effective to secure a like competitive concession from the home office. Even in the rare instances of formal complaint, proof of deliberate violation is always difficult and often impossible. Competitive rate cutting most often takes some indirect form: a misclassification which can be represented as an honest error of judgment, an excessive merit rating discount which may be resolved into a difference of opinion, or an auditor's oversight in the matter of expended pay roll. At best the proceedings can be spun out until the full competitive advantage of the illegal practice has been reaped; at worst, they result in nothing more severe than the cancellation of the particular policy involved.

Competitive underwriting, in fact, like other competitive selling in scattered and unorganized markets, tends inevitably to wide deviations from a common price level. Where tens of thousands of employers are being solicited by thousands of agents, representing thirty or forty insurers, each interpreting classifications, rules and rates in its own way and applying merit rating through its own staff, no approximation to uniformity can be attained. The temptation on the part of a commission agent to obtain business by rate cutting is one which human nature is ill fitted to withstand, and the companies are much too dependent upon their agency connections to exercise effective restraint. Merit rating, indeed, is usually taken out of the agent's hands, but so long as it remains in the hands of the insuring company, the bias of competitive interest cannot be escaped. To permit company classification and rating of risks, then, is to make rate regulation nugatory.

Just in proportion, therefore, that rate supervision has been made effective, both rate making and the detailed application of rates to risks have been removed from the control of individual insurers. At the same time, it has not been thought either expedi-

ent or necessary to vest these vital functions directly in the supervising authority. Such a course would require a government organization as flexible, as well-informed and as ubiquitous as the business to be supervised, and it would substitute the judgment and initiative of government officials for the judgment and initiative of insurance carriers. Rather than adopt this extreme measure, it has seemed the part of wisdom to utilize the extant machinery and information of the carriers themselves, so coördinated as to remove the warping effects of competitive interest. Altogether the most effective instrumentality hitherto devised for this purpose is the representative rating bureau, made up of all compensation insurers operating within the state, and empowered, subject to the approval of the supervising authority, to formulate risk classifications, rules, basis (or class) rates, and merit rating plans, to assign individual risks to existing or special classifications, to apply merit rating through inspection or otherwise, and to scrutinize the underwriting of all risks by means of a policy "stamping office."[13] Bureaus upon this general plan, though with many variations of detail, have been established in New York,[14] Massachusetts,[15] California, Pennsylvania and Colorado.[16] Experience of their actual working has been too brief to afford a decisive test,[17] and there is even some question of their full legality,[18] but their *a priori* advantages are so

[13] The "Stamping Office" receives, examines and approves or disapproves a duplicate of every policy declaration. This practice was first established by the Industrial Commission of Wisconsin under the anti-discrimination law of 1913, and has since been adopted by the rating bureaus of California, Colorado and Pennsylvania.

[14] The order is chronological.

[15] The Massachusetts Bureau accepts company inspections, subject to such verification as may be required.

[16] The Colorado Bureau is in a state of suspended animation, pending determination of its legal status.

[17] The oldest state bureau, the Compensation Inspection Rating Board of New York, dates from midsummer, 1914.

[18] A rate maintenance association might have been held illegal at common law or under anti-trust statutes, but all questions on this head are set at rest by the adequate rate laws, provided these are valid.

The points of attack (fathered especially by the Travelers Insurance Company) upon state compensation rating bureaus are the right of a public official to delegate supervising authority to an unofficial association, and the ability to make the approval of rates or of merit rating conditional upon application by such an association. In reply it is argued that no supervising authority is delegated to the

great that they promise to become a permanent feature of rate regulation.[19] A representative rating bureau, just because it comprises every type of insurer, will ordinarily be impartial as between stock and mutual interests,[20] at the same time that it may fairly be said to embody the collective wisdom of the business. Whence it is at once the most potent agency at the disposal of the government for giving effect to rate regulation, and almost the sole source of advice which is both competent and disinterested. For the routine work of rating individual risks in accordance with the existing code, the bureau supplies a trained and impartial staff, while it brings to bear the collective views of rival insurers upon all those questions which involve the exercise of discretionary judgment or the compromise of opposing interests.

When all is said, however, rate making transcends the limits of any state. Notwithstanding many local variations, there is a striking similarity of industrial technique, and consequently of industrial hazards as well, throughout widely separated territories. By the same token, the problems of industry classification, of classification rules and of schedule rating—to say nothing of statistical and actuarial methods—are common to the whole country. To which it must be added that no state has a sufficient volume of exposure for dependable rate making in every classification or is wholly independent of the experience of other states in more than a very few classifications. Out of these conditions arises the need for a supra-organization to coördinate the activities of territorial rating bureaus. This need has been in part supplied by joint stand-

bureau since all its acts are subject to supervision to the same extent as the like acts of individual insurers, and that the supervising authority may properly make his approval of rates conditional upon their application by an impartial agency—else his approval were a farce. These questions have not been judicially determined.

[19] Local branches of the National Compensation Service Bureau have been recognized as official rating bureaus, for the purposes of merit rating, in Kentucky and Maryland. The parent body is a voluntary association of some twenty stock companies, but these local branches have been opened to non-members, even including mutuals. The great weakness of this plan is that it vests the rate-making function in a single group of competitors.

[20] In the Pennsylvania Bureau the Insurance Department has a casting vote in case of a tie in every committee. During the first year's experience, notwithstanding the great number of controversial subjects passed upon, this power was exercised on only two occasions.

ing committees, representative of the several state bureaus and of the various types of insurers among their constituents.[21] The federative organization so constituted is as yet somewhat invertebrate, but it has at least effected a large measure of uniformity in manual rules and classifications, in the structure of schedule rating and even in the basic pure premiums from which state rates are derived.

Rating bureaus, state or inter-state, be they ever so efficient for their purposes, will not obviate the need for independent knowledge on the part of supervising authorities. The questions to be passed upon involve something more than the maintenance of fair competition among insurers; they extend as well to that equitable distribution of work accident cost with which the state is more immediately concerned. The ends of equity are not served by the mere uniform application of rates, unless these latter are reasonably proportionate to the industrial hazards involved. Neither can such proportionality be lightly assumed of classifications and rates evolved by compromise between competing insurers. To assure the results professedly sought, the whole system of insurance classifications, rates and merit rating should be subjected to rigorous analysis in the light of all available information. Characteristically enough, however, no state which has undertaken to supervise compensation insurance has seen fit to provide facilities at all commensurate with the responsibilities assumed. The actual work of supervision falls, in every instance, upon a subordinate appointee and a handful of clerical assistants, unprovided with technical advisers and without either means or leisure for independent research. It has not been possible, in any of the adequate rate jurisdictions, to compile accident statistics in correlation with insurance classifications and exposed pay rolls, to say nothing of such analyses as would serve to throw light upon the validity of the classifications themselves or the reasonableness of merit rating deviations from basis rates. Yet the raw materials for such statistics, in the shape of accident and pay-roll reports to public authorities, exist in every

[21] The Standing Committee on Compensation Insurance Rates comprises three stock companies, two mutuals, a (competing) state fund, and an insurance department. The Standing Committee on Schedule Rating is similarly constituted. Both these committees meet monthly and to them are referred all manual or schedule rating amendments proposed by the constituent bureaus, though the findings of the Standing Committee are not binding until ratified by the bureaus.

one of these jurisdictions. The failure to make the necessary correlation—a failure attributable as much to divided authority as to insufficient appropriations—is a striking instance of systematic ineptitude.

The argument thus far goes to show that effective supervision of compensation insurance rates imposes far-reaching restraints upon competition. Neither rate making nor the application of rates to individual risks, neither policy forms nor underwriting rules, not even the amount of commissions to be paid for the acquisition of business, is left to the discretion of individual insurers. It only remains to point out that competition so straitened and bound loses many of those attributes which admirers of the competitive system have always ascribed to it. When uniform rates are prescribed by government and uniform underwriting is enforced by a rating bureau, there is little scope for competitive selection of business and less for that competitive adjustment of price to minimum cost of service which the classical economists so fondly expounded. Competitive selection of business is handicapped by the prohibition of discretionary rate cutting upon preferred risks and the competitive advantage of economic management (as respects stock companies) is taken away by the incorporation in basis rates of a uniform expense loading. Even the flexibility which is claimed as a chief advantage of private insurance disappears under rigorous regulation. Quick adaption to changed conditions is impossible when every manual change has to be worked out by representative committees and assented to by supervising authorities. Competition under such conditions tends prevailingly to take the form of salesmanship, more or less disguised as "service."[22] Economic waste, indeed, is the only characteristic of competitive insurance that is untouched by regulation.

[22] It is not denied, of course, that there is competition in real, as well as fictitious, service.